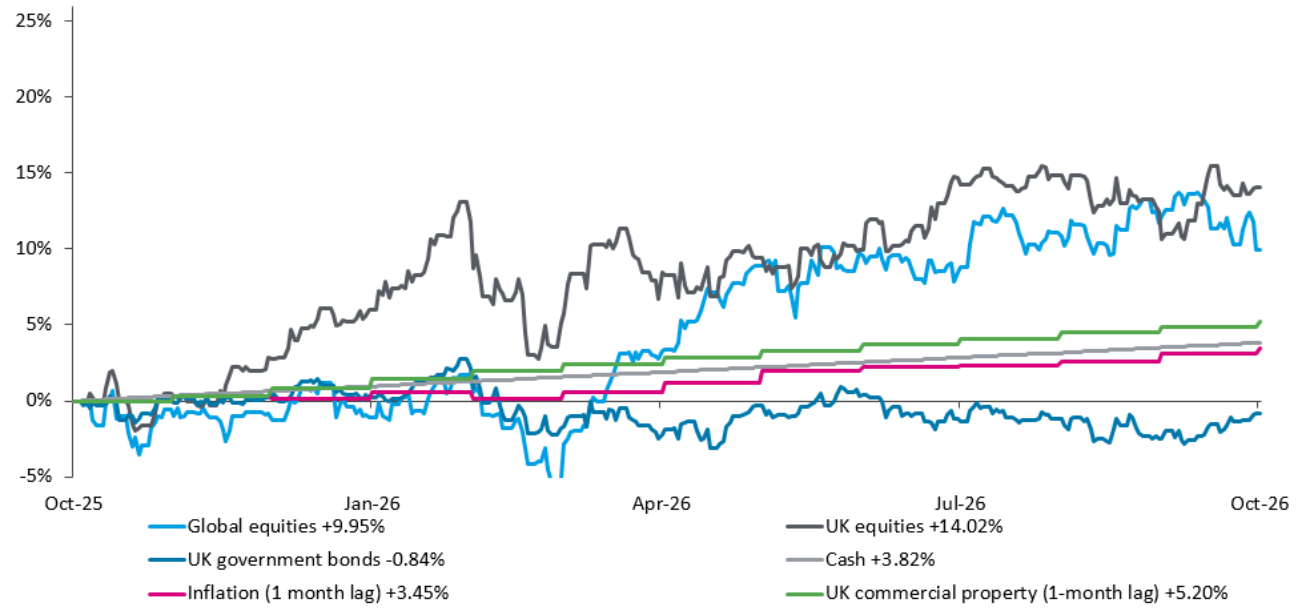
CCLA
GOOD INVESTMENT

Market review

The headlines

- **Share prices fell in October, largely driven by technology companies that are investing heavily in artificial intelligence (AI) equipment.**
- **Inflation continued to rise, but central banks kept interest rates on hold in October. Bond yields moderated from their September peaks.**
- **Company profits are growing at multi-decade highs, which bodes well for shares overall. But the changing cash flow positions of technology firms warrant caution.**

Market returns: World share prices fell in October, largely driven by declines in technology shares.



Sources: Bloomberg returns in pound sterling as of 30 Oct 2026 (31 Oct 2025=0%). Daily data, except for inflation and UK commercial property shown monthly. UK government bond returns as per Markit iBoxx £ Gilts Index. Inflation as per the Office of National Statistics' UK Consumer Prices Index, with a one-month lag. UK commercial property as per MSCI UK Monthly Property Index, estimated for the most recent month. Cash returns as per Sterling Overnight Index Average (SONIA). Global and UK equity returns as per MSCI World Index and MSCI UK IMI Index, respectively. **Past performance is not a reliable indicator of future results.**

Economics and markets news

World share prices fell 0.8% in October. US share prices fell 1.0% and eurozone share prices fell 1.6%. UK share prices, by contrast, rose 1.3%.(1)

Inflation rose because of energy prices. But the US Federal Reserve (Fed) and the European Central Bank (ECB) kept interest rates on hold during October. The Bank of England (BoE) doesn't meet until 5 November.

US and UK bond yields fell from recent peaks. Ten-year US Treasury yields, for example, fell from 5.29% at the end of September to 4.94% at the end of October.(2)

The British pound strengthened to $1.34 and €1.20 during the month. This reduced returns on foreign assets, when translated into pounds sterling. The oil price rose to $113 at the end of October, but fell steeply in early November, after a proposal to end the US-Iran war was circulated.

United States

US share prices fell 1% in October, because investors increasingly worried that the companies that make massive investments in AI now might not reap the hoped-for returns on those investments in future.

- As October started, the shares of most technology companies traded at high valuations, based on optimistic assumptions for future profits.
- In early October, investors became nervous about rising debt levels at so-called 'neocloud' companies. Neoclouds are mostly private firms that are borrowing heavily to build data centres. They hope to rent those data centres to companies offering AI services such as Microsoft, Facebook owner Meta, OpenAI and the like. So, they need those clients to generate large and growing AI revenues.
- On 8 October, OpenAI, which operates ChatGPT, clarified to investors that its net annualised revenue is c.$50 billion rather than the c.$70 billion that most investors estimated. Lower revenues for OpenAI mean lower potential revenue for neocloud companies, and lower potential revenue for publicly listed companies that sell goods and services to OpenAI. Those include, e.g., chipmaker Nvidia, AI server producer Dell, cybersecurity provider CrowdStrike and many others.
- As a result, the assumptions that underlie valuations across the tech sector re-set to lower levels in mid-October. Technology share prices fell but prices rose in the defensive sectors that investors turned to instead, such as consumer staples and utilities.
- On 29 October, Google's owner Alphabet revealed that third-quarter advertising revenues from its search pages were down, in part because it offers 'AI mode', which doesn't feature advertising. Alphabet also revealed that its third-quarter capital expenditure had risen 114%, year on year (yoy), to $51 billion for the third quarter alone. That cash flow outlay was much higher than the company's $42 billion operating cash inflow. It means that Alphabet generated negative free cash flow in the third quarter, for the first time in its history. As a result, Alphabet has not bought back any shares this year (which is one of the ways in which these companies customarily return cash to their shareholders). Instead, it had to raise debt and issue new shares.
- The next day, 30 October, retailer and cloud hosting company Amazon revealed negative free cash flow of $42 billion over the 12 months to 30 September. Chip maker Intel published a disappointing forecast for fourth-quarter revenues, and its share price nearly halved over the month. Intel has had negative annual free cash flow since 2022, which the company expects will continue until at least 2027.

Free cash flow is an important source of dividends to shareholders. Understandably, therefore, the absence of free cash flows among some bellwether firms weighed down share prices in the communications and information technology sectors in October.

But share prices in all other sectors advanced, as investors turned to more defensive industries. The shares of energy companies like ConocoPhillips, health care companies like Eli Lilly and utility companies like Exelon were among the best performers in the US.

Personal consumption expenditure (PCE) inflation rose from 3.4% in August (yoy) to 3.6% in September. But, after its rate hike in September, the Fed kept rates on hold in October. Ten-year US Treasury yields fell from their recent peak of 5.29% at the end of September to 4.94% at the end of October.

United Kingdom

In contrast to the US stock market, share prices of UK-listed firms rose 1.3% during October. That's because the UK stock market includes few of the AI, tech or communications firms that fared poorly in October.

Instead, credit bureau Experian, tobacco firm Imperial Brands and pest control company Rentokil were among the UK market's strongest performers.

Chancellor John Healey's first Autumn Budget also helped UK shares' performance in October. The budget he delivered on 28 October avoided significant tax rises, delivered a less severe surcharge on bank profits than expected, and boosted aerospace and defence firms by targeting an increase in defence spending to 3% of gross domestic product (GDP) by 2030.

Importantly, the Chancellor preserved a £15 billion buffer of so-called 'fiscal headroom', as forecast. As a result, the yield on 10-year gilts (UK government bonds) fell from its peak of 5.48% in early October to 5.28% at the end of the month.

UK consumer price (CPI) inflation rose from 3.1% in August (yoy) to 3.5% in September. The BoE's monetary policy committee did not meet in October, but it is widely expected to raise interest rates when it meets next, on 5 November.

Other markets

Eurozone share prices fell 1.6% in October, mainly weighed down by technology shares, like the US markets. By contrast, health care and some consumer discretionary firms like EssilorLuxottica, Adidas and L'Oréal were among the month's best performers.

Eurozone inflation rose sharply from 3.2% yoy in August to 3.8% in September. But the ECB kept rates on hold during October, because it didn't see a rise in underlying inflation or 'second-round' effects on wage growth. ECB President Christine Lagarde announced that she will step down in February 2027, ahead of the scheduled end of her term.

Weakness in the technology sector led **Japanese** share prices 4% lower during the month. Softbank, a technology holding group and Japan's fourth largest firm by market cap, lost a third of its value in October.

The Bank of Japan declared that it had met its target of raising underlying inflation to 2% during October, a

historic milestone in the country's 30-year battle against deflation.

Chinese share prices lost another 7.2% during October, which brings year-to-date performance down to -18.1%. Just as in the US, the Chinese AI bubble deflated somewhat during the month.

In addition, investors continued to feel discouraged about the Chinese government's piecemeal approach to economic stimulus. Domestic spending was weak during the country's Golden Week holiday (1-7 October), Chinese company profits are shrinking, and Chinese bond yields rose during October.

(1) Source: MSCI (total return, net of withholding tax, in local currency), except where stated
(2) Sources: US Fed, Bank of England, European Central Bank

Looking ahead

The shares of businesses aiming to offer AI services at scale, such as Google, Microsoft and Meta, performed poorly in October. That poor performance was caused by the fact that these companies' free cash flows are shrinking, because they're investing heavily in micro-chips and data centres. By contrast, the share prices of businesses considered at risk of AI disruption rose 11%.

Does this mean that the rally in technology shares is over? By extension, does that mean that the broader market rally is over? Our answer is a qualified 'no'.

For starters, these tech businesses' revenues from cloud services (which includes their AI businesses) continue to grow at breakneck pace, of c.80% per annum for Google, c.40% for Microsoft etc.

And, according to the US Census Bureau (October 2026), only 23% of US businesses currently use AI at all. So, the revenue potential for tech businesses offering AI is large.

What's more, listed US technology companies are growing their revenues at an annual rate of 85% and listed companies overall at 28%. That's nearly five times long-term expected profit growth, which would be the nominal growth rate of the economy of c.5%-6%.

We think it would be unwise to call the top in a stock market in which corporate profits are rising at 28% p.a.

And we continue to maintain significant exposure to AI businesses in the portfolios we manage.

But our portfolios are less exposed to AI businesses than the market average. That's, firstly, because we worry about the cash flow implications of the AI rollout.

Before AI, many tech businesses ran highly cash-generative 'capital-lite' business models. Google, for example, operates its ad business without factories or warehouses, and its clients self-service to pay up front for the ads that Google later places on their behalf.

In this new, AI-driven era, however, tech businesses buy lots of expensive chips to offer AI services to their clients, and house those chips in expensive data centres that consume large amounts of energy. All those outlays lower the cash that these firms generate.

In addition, listed companies' profits are as far above their long-term average as they've been for nearly a century. And debt levels are at multi-decade peaks for corporations, governments and households.

In summary: we believe that continued profit growth justifies the participation of the funds we manage in this stock market. But, as shown in October, the changing cash flow positions of tech firms and related concerns warrant a cautious, quality-focused stance.

Our focus on selecting quality shares means that the profit growth and the cash flow growth for these shares are strong, but not as strong as the market average. In exchange, the portfolios we manage at times have lower risk than the broader market. We consider this a well-founded stance at a time when market volatility is on the rise.

Glossary

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